THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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The Fix is In

> **"Number crunchers, nerds, and pure geniuses have invaded the world's financial markets. Many of these people see Wall Street not as a crap shoot but as a mathematical puzzle where their ideas about risk and reward, stasis and chaos can be tested in real time. And as this new breed takes over, the products being traded – the products that make big money and move markets – are becoming ever more abstract."**
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> **The Death of Money**
> **Joel Kurtzman, 1993**

Kind words from the assembled financial leaders of the G7 countries have stemmed the dollar's relentless decline, at least for the moment. But it will take more than words to reverse the bearish trend of the U.S. currency. Only an aggressive monetary tightening by the Federal Reserve offers any hope of breaking the downward spiral.

Even that may not suffice. The dollar's fall is not the result of a speculative attack that can be beaten back by a display of central-bank resolve. It is no whim of the markets. Rather, it stems from the economic fundamentals, namely, from America's huge current-account deficit, which has created a monumental, global dollar overhang.

In any case, the question is academic. The Fed clearly is unwilling to risk doing further damage to the wildly overleveraged U.S. financial system. In this policy of dollar neglect, the Fed is aided and abetted by the Clinton administration, which hopes to use the weak dollar to bludgeon Japan into submission in ongoing trade talks.

This is a dangerous game. The slumping dollar obviously poses a grave threat to the fragile world recovery. This appears of surprisingly little consequence to U.S. officials, even given their traditional indifference to the dollar. It appears the United States has renounced whatever remains of its leadership role in global economic affairs.

But in ignoring the dollar's plight, U.S. officials are running enormous risks. To a large degree, the health of U.S. financial markets is in the hands of the foreign central banks, primarily the Bank of Japan.

The BoJ isn't just preventing a total dollar collapse through its massive interventions. It also is providing crucial support to the U.S. bond market by investing its dollars in U.S. Treasuries. As we explain, these purchases have been instrumental in this year's bond rally, which in turn has driven the Dow to record highs.

But this massive influx has perverse effects. By artificially pumping up U.S. bond and stock prices, it makes them unattractive to foreign investors, discouraging private capital flows. By sustaining U.S. economic growth, it prevents a correction in the U.S. current account. Inevitably, this will lead to further pressure on the dollar.

How long will the Bank of Japan play this desperate game? Should the United States press its trade offensive too hard, we think there is a risk the Japanese will retaliate, perhaps by withdrawing support for the Treasury market, or even by driving up the dollar price of gold. This would trigger renewed bear markets in bonds and stocks.

For investors, the significant fact is that the U.S. financial markets essentially are a rigged. This makes it difficult if not impossible to predict future moves in interest rates or exchange rates. The politicians are in control now.

EMPTY RHETORIC

As was to be expected, the finance ministers and central bank governors of the G7 group of leading industrial countries could agree only on empty rhetoric about the desirability of a stable dollar following their meeting in Washington last month. The imbroglio starts with the complacent claim by American policymakers and Wall Street that the "dollar crisis" is not that at all, but rather a yen crisis, a DM crisis, or both.

According to this school of thought, the important thing is that the dollar has dropped relatively little on a trade-weighted basis. Yet even on this basis, the dollar is down some 5-6% so far this year. This is not peanuts, especially considering the extreme weakness of some of the other currencies involved.

Also giving comfort is the extraordinary bullishness of the U.S. bond and stock markets. Even as the dollar has collapsed against the yen and the mark, U.S. stock prices have surged to new records, while bonds have staged a solid rally. What is the better gauge of the U.S. economic situation: the dollar, or the stock and bond markets? In Wall Street's view, the latter two correctly reflect the fact that the U.S. economy is in better shape than those of its major trading partners.

In the same vein, the yen's surge is seen as defying any economic logic, considering that Japan's economy is on the borderline of depression and a financial crisis. Current conventional wisdom simplistically associates strong economies with strong currencies and weak economies with weak currencies. Last year, American brokerage houses and hedge funds lost fortunes speculating that the yen would plummet against the dollar, thanks to rising U.S. interest rates. Though many of these unfortunates still think they were right about the fundamentals, they ultimately had to give up with huge losses.

Admittedly, the U.S. economy has turned in an excellent performance over the past few years – far better in terms of GDP growth, yet with moderate inflation, than Japan and Germany. Only Canada has done better. By these measures, the U.S. dollar should be rising, and the Canadian dollar should be at the top of the international currency league. Why, then, are they so weak?

To be sure, there now is a lot of thinking along these lines in the financial markets. It essentially implies that the dollar's plunge versus the hard currencies has taken on the aspect of a bubble, causing exaggerated moves in exchange rates. Once the bubble is burst, this comforting reasoning goes, the dollar eventually should recover in coming months.

In addition, there is of course the widespread perception that the U.S. dollar is by now grossly undervalued in terms of relative domestic purchasing power. Though this reasoning has proved a dud for many years, it remains in the backs of the minds of many frustrated foreign dollar holders.

For these and other reasons, we rather wonder about the depth of the present, endemic dollar bearishness. We think few people are bearish enough. Few, very few, can imagine that this downtrend of the dollar will last. In Europe, characteristically, the usual question posed by investors is when to buy dollars. A strong rebound, sooner or later, generally is taken for granted. Evidently, this is the key question for international investors, lenders and borrowers.

Nobody can really say how deep the dollar is going to fall in the short run, let alone in the long run. But in order to make a reasonable assessment of the situation, we need in the first place a clear understanding of the forces currently at work in the currency markets. We dare say that this has been our foremost endeavor at all times.

Our views, as explained in past letters, rest on one basic fact: The currencies now under downward pressure all belong to countries that have large, structural imbalances, but lack corrective policies that investors consider

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (April 28)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	7.9%	7.2%	-0.9%	-3.9%	12.4%
Canada	-0.5%	1.6%	0.3%	-3.5%	8.1%
France	4.4%	2.0%	-11.4%	-12.6%	11.4%
Germany	5.5%	-4.3%	-10.2%	-11.2%	5.5%
Hong Kong	-5.3%	-2.1%	-8.8%	-17.8%	20.0%
Japan	0.8%	-14.8%	-14.8%	-22.0%	9.3%
Mexico	7.0%	-17.5%	-14.5%	-31.4%	35.4%
Spain	6.7%	0.1%	-12.2%	-15.6%	7.9%
U.K.	2.8%	4.9%	2.9%	-1.5%	11.8%
U.S.	2.2%	12.1%	14.2%	0.0%	16.6%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (April 28)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	9.69	-38	-35	151	-102	151
Canada	8.36	-23	-78	22	-132	22
France	7.82	-10	-45	100	-61	114
Germany	7.04	-12	-58	44	-72	57
Japan	3.48	-33	-110	-73	-148	16
Spain	12.04	-41	21	277	-52	277
U.K.	8.43	-4	-28	57	-60	63
U.S.	7.06	-8	-77	7	-98	15

Exchange Rates

Versus U.S. Dollar, % Change

Country (April 28)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.37	0.0%	-6.4%	2.2%	-7.3%	3.8%
Canada ($)	1.36	3.4%	3.3%	1.9%	-1.1%	4.8%
France (*f*)	4.92	-0.9%	7.8%	13.7%	-3.2%	14.3%
Germany (DM)	1.39	-0.1%	10.4%	16.4%	-2.7%	17.0%
Japan (¥)	84.3	5.1%	15.3%	16.8%	4.6%	20.0%
Spain (Pt)	123.2	3.7%	6.4%	9.2%	-1.4%	11.0%
U.K. (£)	1.61	0.8%	3.1%	6.5%	-1.7%	8.3%

credible. Just as clear is the common cause that's hitting the currencies of these countries. For the first time in many years, capital inflows generally are falling short of their current-account deficits.

The second, salient point to see is that this is not merely a temporary disturbance in the orderly recycling of the excess savings of the surplus countries. It's lasting nature lies in the fact that the two main sources of finance for debtor countries – Germany and Japan – definitely have dried up. Together, these two countries generated a current-account surplus of nearly $800 billion during the 1980s, which was recycled into the deficit countries by their banks and investors.

Those days are over, as we explained in our last letter. Due to the demands of reunification, Germany no longer has surplus capital to export. Japanese investors, meanwhile, are caught in a vicious liquidity squeeze, making it impossible for them to recycle Japan's still-formidable current-account surplus.

Seen in this light, what we are witnessing can best be described as a global debt crisis involving all the major debtor countries. Whatever the immediate catalyst for the dollar's accelerated decline, the underlying problem is the huge U.S. current-account deficit persistently flooding the rest of the world with excess dollars.

Whose fault is that deficit? And whose job is it to correct it? It used to be conventional wisdom that the burden of adjustment falls on the country with the deficit because ultimately it will run out of foreign credit if it lives beyond its means for too long. If it fails to curb its deficit, it must do whatever is necessary to keep its asset markets attractive to foreign investors.

But while U.S. policymakers have been quick to impose the traditional rules on Mexico and other lesser debtors, they always have refused to accept such harsh medicine themselves. Instead, they perpetually blame the creditor countries, demanding that they reflate, or inflate, to accommodate U.S. profligacy. In that sense, the current U.S. bickering with Japan is nothing new.

Another quirk in American thinking about their huge external deficit and the dollar is the view that the normal balance-of-payments constraints do not apply to the United States because the dollar is the world's main reserve currency. In this view, the United States simply can print the money needed to finance its deficit. If other countries

want a stable dollar, it is their job, and in particular the job of their central banks, to buy and hold the excess dollars.

Pointing to the fact that the dollar has fallen only moderately when measured against a trade-weighted average, U.S. policymakers openly repudiate any international responsibility. They not only refuse to curb the huge U.S. current account deficit, they also reject any obligation towards their foreign creditors, who presently hold more than $3 trillion in dollar assets. Reckoning that the falling dollar will help boost U.S. exports, they have no qualms about undermining their own credibility on a grand scale.

THE GLOBAL DEBT CRISIS

For this reason, the real danger inherent in the dollar's drop may not be inflation but rather the risk of causing outright panic among foreign investors. Though the dollar may have remained rather stable when measured against a trade-weighted index, it has virtually collapsed against a debt-weighted index, that is, when measured against the currencies of the creditor countries that mainly have financed the U.S. current-account deficit.

According to calculations by Merrill Lynch, at an exchange rate of 88 yen to the dollar, Japanese losses on dollar assets total about $585 billion. Considering the stupendous size of these currency losses, it's amazing that there has not been more panic selling.

As Merrill Lynch stresses, such calculations are extremely crude, but they do give an idea of the devastating effects of the dollar's slide on the balance sheets of Japanese banks and other financial institutions. Characteristically, it is not customary among U.S. policymakers to mention the horrendous wealth effects thus imposed on America's foreign creditors.

Nor is it customary to think about the probable negative long-term implications of this official carelessness for the future financing of the U.S. current-account deficit. There is a widespread cynical view, obviously shared by Wall Street, that many foreign central banks will feel compelled to purchase almost unlimited amounts of dollars in order to prevent an excessive appreciation of their currencies.

To be sure, record-high dollar purchases by central banks in the past few months have braked the dollar's plunge considerably. But Wall Street has yet another reason to view the weak dollar as a blessing for the U.S. financial markets. In a perverse way, the falling dollar has spurred this year's surprising bond rally. This is in complete contradiction to what could ordinarily be expected in a major currency crisis.

Typically, currency declines spill over into the capital markets, in particular the bond market. Such was the result of the 1987 dollar crisis, which led to crashes in both U.S. bonds and stocks. After all, why would investors want to hold bonds and stocks whose currencies they shun? But this year, dollar weakness miraculously has translated into a powerful bond-market rally. How could this be?

For Wall Street and its claque of paid propagandists, this astonishing bullish move in U.S. bonds and stocks is just more proof of the excellent fundamentals underpinning the U.S. economy and financial markets. Strangely enough, by international comparisons, U.S. bonds have staged by far the strongest rally since last November, with yields at the long end falling nearly 100 basis points. German bond yields, on the other hand, have fallen little more than 50 basis points, despite the strong DM.

Admittedly, this new bull run of the U.S. bond market has taken us by surprise. As for the U.S. stock market, we think it simply shadows the bullish bond market, with the additional help of heavy corporate repurchases of shares.

Our expectation that U.S. long-term rates would continue to rise was based mainly, but not solely, on our expectation that U.S. commercial banks, faced with soaring credit demand and stagnating deposits, would necessarily turn from heavy bond buyers into heavy bond sellers in order to fund accelerating credit expansion. This would have been the normal cyclical pattern.

Actually, U.S. banks did start selling bonds in the August-September time period, but they relied even more on repo and Eurodollar borrowing to finance their credit growth. The following table illustrates the drastic changes in bank balance sheets during this period.

Changes in U.S. Bank Credit
1991-1995 QI, in billions at annual rates

	1991	1992	1993	1994 H1	1994 H2	1995 Q1
Securities	$110	$96	$75	$122	-$54	-$34
Loans	-$7	$1	$81	$124	$245	$316
Total	$103	$97	$156	$246	$182	$282

Source: Federal Reserve

During the five quarters from the end of 1993 to the end of March 1995, U.S. commercial bank investments and loans expanded altogether by $291 billion. Oddly, however, this rampant expansion occurred at a time of zero growth in bank deposits, which just as an aside, also explains the unusual weakness in money growth during that period. Neither repo loans nor Eurodollar borrowings are counted in the money supply. They are not even subject to any reserve requirements.

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THE BANK OF JAPAN TO THE RESCUE

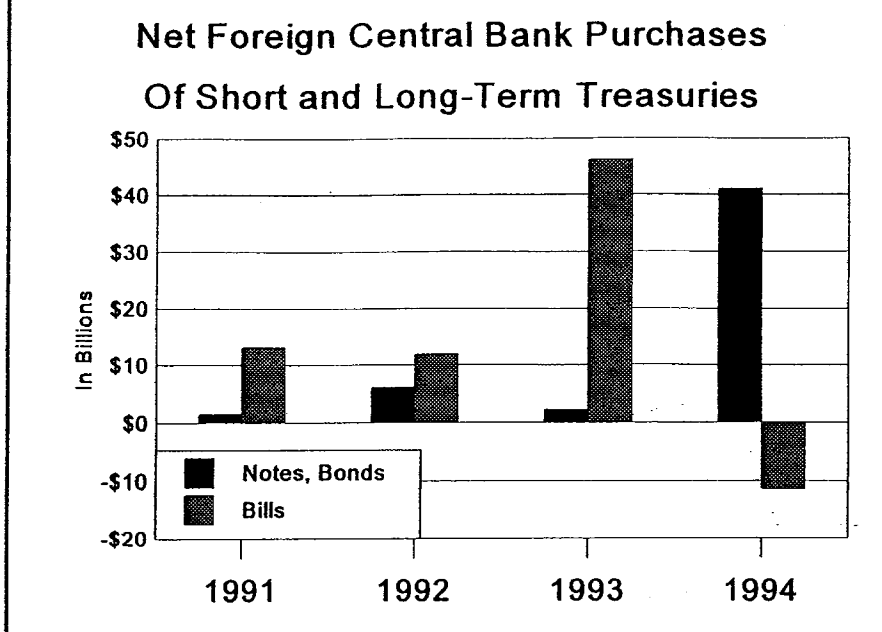
But to return to our earlier question: How could a bull run in the U.S. bond market occur simultaneously with a near collapse of the dollar? It is the direct result of soaring dollar purchases by foreign central banks. When these institutions buy dollars through the Federal Reserve, those holdings instantly are put to work in the U.S. Treasury market. The weaker the dollar, the more greenbacks foreign central banks must buy to reign in their own appreciating currencies, and the bigger their demand for U.S. Treasuries.

The facts are fairly straightforward. As we reported in our last letter, foreign central banks in the last three years have sharply stepped up their purchases of U.S. Treasuries, to the point where they now own some $440 billion, or about 13% of the outstanding U.S. national debt (that which isn't already owned by the Fed or by the various federal government trust funds). In fact, one could make the argument that foreign central banks played a crucial role in the early 1990s in driving U.S. long-term interest rates to levels low enough to spark the present economic recovery.

When we say central banks, we are talking almost entirely about the Bank of Japan and the central banks in those developing countries, such as China, Malaysia, Hong Kong, Singapore and India, that were targets of the great emerging markets bubble of 1992-93 that attracted so many billions of dollars from U.S. investors. Japan's foreign reserves alone rose from $68.7 billion at the end of 1991 to $122.8 billion at the end of 1994. Presently, they exceed $140 billion.

not No less interesting has been the recent, seismic shift in the maturity of central-bank Treasury holdings. Traditionally, foreign central banks have tended to put their dollars in short-term Treasuries, usually 3-month, 6-month or 1-year bills. Such purchases have only an indirect impact on longer-term bond yields. But last year, as the U.S. bond market crumbled, foreign central banks abruptly started to buy coupon Treasuries on an enormous scale. In fact,

while their holdings of Treasury bills actually *fell* by $11.4 billion in 1994, their holdings of notes and bonds soared by $41.6 billion.



Sources: Federal Reserve, U.S. Treasury

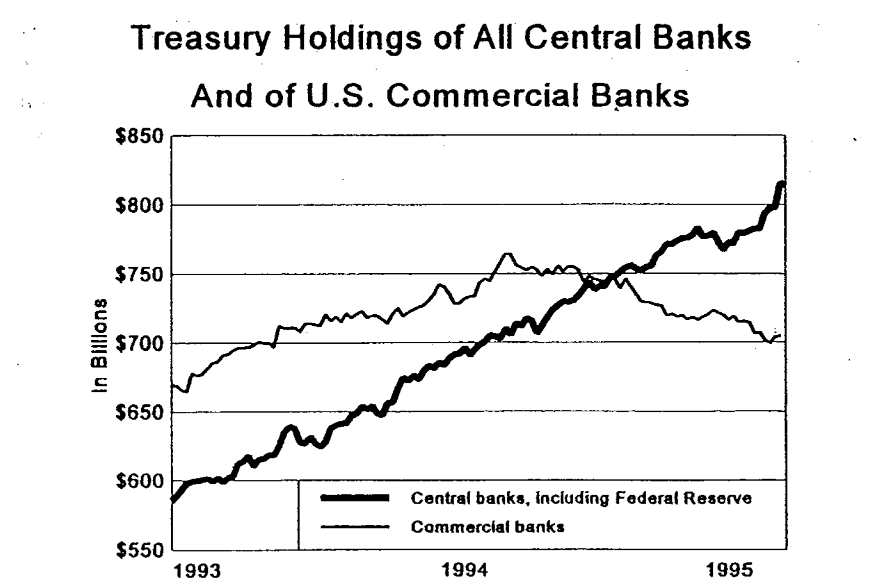
This shift certainly played a key role in putting a floor under last year's bond debacle. Given the magnitude of the purchases, the Bank of Japan almost certainly was responsible. We can only wonder whether this was an intentional move by the BoJ, perhaps aimed at shielding Japanese private financial institutions, such as the insurance companies, from further huge losses on their Treasury holdings, losses that would have further eroded their already strained capital base.

In any case, one significant aspect of the BoJ's support was that it enabled the U.S. bond market to absorb massive selling by other central banks – especially in Mexico and other Latin American countries — as well as by overleveraged U.S. speculators and institutions such as Orange County.

BAILING OUT U.S. BANKS – AGAIN

Even more importantly, foreign central bank support, combined with the Fed's own huge bond purchases, has enabled the U.S. bond market to absorb the selling pressure generated by the U.S. commercial banks over the past year, as illustrated by the chart below. Once again, foreign governments are playing a key role in perpetuating the U.S. economic recovery.

This year, the dollar's free fall has forced foreign central banks into even more frenzied rounds of Treasury purchases. In the twelve weeks ending April 19, they bought no less than $42 billion worth – an amount equal to nearly 20% of the entire annual federal budget deficit, and one-quarter of the U.S. current-account deficit. Again, the BoJ appears to have accounted for the lion's share of those purchases.



Source: Arbor Trading Group

Given the monumental scale of the BoJ's support operation, it's actually little surprise the U.S. bond market has staged an impressive rally. Of

course, central banks are not the entire story. As the soft-landing scenario has gained popularity, leveraged speculators have jumped back into the bond market. Yet we regard these leveraged speculators more as followers than leaders. They chase the trend that the central banks have set.

THE U.S. BOND MARKET IS RIGGED

We have undertaken this detailed analysis in order to make one thing perfectly plain: The U.S. bond market is no longer a free market. It has been heavily rigged by the central banks and the leveraged speculators who follow their lead. This not only holds bond yields artificially low, it also makes it virtually impossible to forecast the direction of U.S. interest rates, exchange rates or the economy by analyzing the underlying fundamentals.

To us, this scenario is preposterous: So many central banks are propping up the dollar, with the glaring exception of the Fed. If it wasn't such a serious matter, we would call it a farce. How long will it last? And how will it end?

For the time being, it is widely taken for granted that the dollar at some point will stabilize and recover on its own accord. After all, haven't the G7 declared that exchange rates have moved "beyond the levels justified by underlying economic conditions"? Their backs to the wall, the authorities appear to hope that such rhetorical flourishes will prove self-fulfilling – that is, by speaking out in unison for a change, they may frighten the dollar bears.

Unfortunately, such a happy ending contradicts historic experience. The dollar's slump is not a whim of the markets. It's driven by a wave of a dollar inflation spilling into a world where trillions of dollars already are zooming around. Finally, investors and foreign-exchange traders are realizing this dollar decline is not just a cyclical fluctuation, but part of a long-run downtrend. As a result, there is less confidence currency losses will be offset by future gains. At the same time, U.S. bonds and stocks look unattractive to foreign investors at their present elevated price levels.

In this sense, Japan's support efforts ultimately are self-defeating. By holding U.S. bond yields artificially low, and the dollar artificially high, the BoJ discourages what little private Japanese investment might otherwise flow into U.S. markets. Low bond yields, meanwhile, could delay a U.S. recession, preventing any significant improvement in the current account. This would continue to push the yen higher, forcing the BoJ to buy still more dollars, and more Treasuries.

Unfortunately for Japan – and for the dollar bulls – there appears to be no way out of this trap. Both the liquidity and the capital base of Japan's corporations and financial institutions have been ravaged by horrible losses on both their domestic and foreign assets, such as stocks and real estate, easily totalling in the trillions of dollars. Even if U.S. stock and bond prices were temptingly low, which they most definitely are not, there is little chance of sizable private capital inflows into U.S. financial assets.

During the 1980s, the appreciation of the yen was held in check by huge capital outflows. But these came to a screeching halt in 1989-90 when Japanese real estate and stock prices collapsed. What postponed the current crisis? As their liquidity situation deteriorated in the early 1990s, Japanese banks and other institutions began large-scale repayments of their foreign, dollar-denominated debts, debts they had incurred to finance their international speculation. These repayments required the conversion of yen into dollars, supporting the U.S. currency. But once those debts were retired, the dollar began its sharp descent.

Interestingly enough, despite the continuing domestic liquidity squeeze, Japanese long-term capital outflows recently have risen again, to $109 billion last year. But their direction and currency composition have changed dramatically. While in the 1980s they overwhelmingly flowed into the United States, and thus into dollars, Japanese capital exports during the 1990s have been mostly denominated in yen, and largely directed to other Asian countries. This development has left those yen borrowers dangerously exposed in the current crisis, as we explain below.

What has to happen to strengthen the dollar? If anything can, it is a further interest-rate hike by the Fed to at least 7%. We see no alternative. But for the Fed, as well as for other U.S. policymakers, this is an anathema because the U.S. economy already is slowing, while inflation still is considered modest.

Recently, Fed apologists have seized on another convenient excuse for doing nothing about the dollar. Higher U.S. interest rates, it is said, would not provide a lasting solution to the yawning U.S. trade deficit, because that gap reflects structural problems, such as a lack of domestic savings, that cannot be corrected by monetary policy.

This is utter nonsense. A main cause of the soaring U.S. trade deficit has been an unprecedented consumer borrowing binge, fueled by excessive monetary ease. In second-half 1994, consumer debt surged at an annual rate of $388 billion. This compares with $171 billion in 1991 and a peak during the 1980s of $291 billion in 1988.

These and other figures virtually scream that America is consuming too much while saving and investing too little. The government is living on borrowed time. So is the consumer. If such overconsumption lasts too long, it essentially becomes structural, meaning that the demand and output structures of the economy adjust accordingly. But who else other than the Fed has fueled this borrowing binge?

Of course, the U.S. economy's big structural shortcomings are its miserable savings and investment ratios. Yet low savings and investments do not and cannot generate trade deficits just by themselves. That always requires the creation of domestic demand in excess of potential domestic output. Looked at in this way, the truth is that a current-account deficit is always and everywhere a monetary phenomenon.

So is U.S. monetary policy too tight, or too easy? In addition to the big trade deficit, we count at least six other obvious symptoms of the Fed's monetary looseness. In short, these are the reasons why the Fed should raise rates:

- The falling dollar, down 10% against the DM and 15% against the yen this year alone.
- A sharp increase in monetary velocity to record-high levels.
- Booming financial markets, including a rally that has pushed the Dow up nearly 500 points the past three months.
- Aggressive bank lending, with a corresponding decline in credit quality.
- A renewed consumer borrowing binge.
- A vast excess of credit and investment flows over available domestic savings.

In the last analysis, current U.S. trade and currency policies boil down to what in the 1930s became ill-famed as the beggar-thy-neighbor strategy, or competitive devaluation. Basically, America is using a loose monetary policy to implement a massive, deliberate depreciation of its currency for competitive purposes.

For America, this equation of "jobs" with a weak currency is a longstanding tradition, dating back at least as far as President Franklin Roosevelt, who devalued the dollar against gold by 40% from October 1933 to February 1934, at a time when the United States was running a sizable trade surplus. In order to pretend to the world that the dollar's devaluation was caused by market forces, and not by manipulation, he let the U.S. currency float.

The story of how this came about is told in the diaries of Roosevelt's Treasury Secretary, Henry Morgenthau (The Morgenthau Diaries, V – The Paradox of Poverty in Plenty, *Collier's* October 25, 1947). In Morgenthau's words:

"A more basic program to meet the commodity price deflation was the attempt to raise the price of gold by government purchases of gold at high prices. The program was based on the theory of Professor George Warren of Cornell that if the price of gold were to increase, commodity prices would rise again. I had a telephone installed in the Cabinet room to keep track of the gold purchases. FDR was in a grand humor. 'I've had shackles on my hands for months now,' he said, 'and I feel for the first time as though I had thrown them off.'

"(FDR) really enjoyed the shock his policy gave to the international bankers. Montague Norman of the Bank of England, whom FDR called 'old pink whiskers,' wailed across the ocean: 'This is the most terrible thing that has ever happened. The whole world will be put into bankruptcy' . . . The President and I looked at each other, picturing foreign bankers with every one of their hairs standing on end in horror. I began to laugh. FDR roared."

Gold bulls take note. This is the way the price of gold was driven up during the Great Depression. It had nothing to do with market forces. Ultimately, all gold in private ownership was confiscated by the government.

As bad as Roosevelt's behavior was, we would say present U.S. policies are even worse. When FDR devalued, America was a creditor nation. Today, it is the world's biggest debtor. The present U.S. devaluation amounts to a massive debt default, as most of America's creditors are based in countries whose currencies are appreciating.

THE LIQUIDITY PARADOX

Our misgivings about developments in the United States have yet another cause, one that we have addressed repeatedly in past letters. It concerns the persistent, sharp downtrend in domestic liquidity as measured by the ratio of bank deposits to incomes, debts and asset values.

The great monetary paradox of the financial boom of the 1990s was that it coexisted with the slowest broad money growth in the entire postwar period. During the four years from the end of 1990 to the end of 1994, U.S. M3 rose by a paltry 3.4%, compared with a 21% gain between 1985 and 1989. Yet total credit grew in the 1990s by $3.35 trillion. In terms of money growth, U.S. monetary policy thus appears to have been extremely tight. But in terms of credit growth, it actually was extremely loose. In exploring this unprecedented discrepancy between the growth of credit and money, we have identified four specific causes behind it:

- An unprecedented shift in lending away from banks to non-bank financial intermediaries and securities markets. Only bank lending creates the deposits that are included in the money supply.

- An unprecedented shift in bank funding from customer deposits to alternative sources, in particular Eurodollar and repo borrowing.

- An unprecedented collapse in liquidity preference, as investors dashed from cash into bonds and stocks.

- The huge current account deficit. This has the monetary effect of transferring dollars from American consumers and businesses to foreigners. As private foreign investors for the most part are not recycling these dollars into the United States, they end up in the Euromarkets, and for the most part are lent back to U.S. banks.

Of these four processes, the first three have one thing in common from a monetary view: They finance spending on goods or assets not from a growing money supply but by a more intensive utilization of the existing money stock, or in conventional jargon, by increasing money velocity.

In the short run, rising money velocity can be an adequate substitute for money growth. But in the long run, it strains balance sheets, as debts rise out of proportion to liquidity as measured by broad money. In this way, U.S.

consumer balance sheets have deteriorated dramatically in the last few years. While consumers' total liabilities have surged by 38% since 1989, to $4.8 trillion, their holdings of bank deposits have declined slightly, to $3.1 trillion. This was the result of a drastic portfolio shift into bonds, stocks and mutual funds.

Here, of course, is also the explanation of the anomaly that the U.S. financial markets have been booming in the face of stagnant money growth. Bond and stock purchases clearly have been financed from the existing money stock, driven by non-bank leveraging and a flight from low-yielding cash. While this flight has slowed, it has not yet reversed, even though the Fed has raised short-term interest rates substantially over the past year.

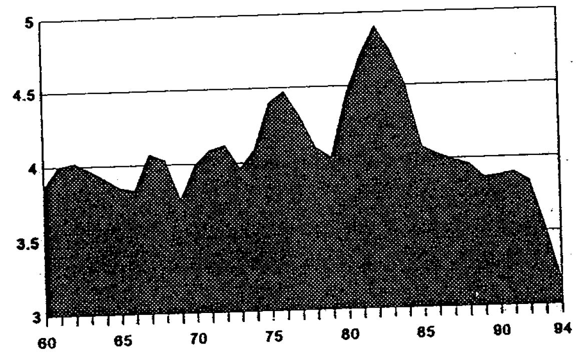
In large degree, this persistent bullishness reflects the support of the central banks, who have supplemented private money flows with their own massive bond purchases. Without that support, the financial bubble clearly would have collapsed last year. But the reluctance of private investors to abandon ship also suggests higher rates haven't yet given enough luster to cash returns. Seemingly, investors still expect better yields in bonds and stocks.

The one thing that would shatter this syndrome would be a further hike in short rates to the 7-to-7.5% range, raising them above long rates and inverting the yield curve. This would push the horde of leveraged bond speculators into a loss-making position, setting in motion a scramble for liquidity. In our view, this is why the Fed is terrified of taking that last step.

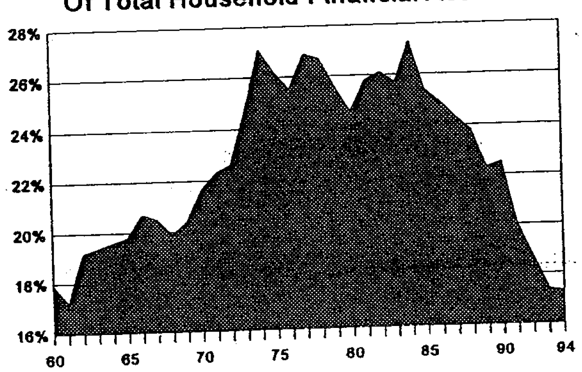
It is an understandable fear. For a perverse characteristic of the liquidity crunch is its self-perpetuating nature. To put it crudely: Velocity tends to drive out liquidity. This can be seen clearly in the tendency of U.S. banks to fund growth with funds borrowed in the Euromarkets. These funds do not carry reserve requirements, so their availability cannot be directly manipulated by the Fed. Yet because U.S. banks have had such liberal access to Euroborrowings, credit conditions have remained quite loose.

The Liquidity Crunch

Ratio of Bank Deposits
To Consumer Debt



Bank Deposits as a Percentage
Of Total Household Financial Assets



Source: Federal Reserve

As a result, the Fed has felt compelled to raise the federal-funds rate from 3% to 6% – much higher, we suspect, than it anticipated when it began raising rates in early 1994. But because the banks now prefer to borrow elsewhere, the demand for federal funds is weak. This has forced the Fed to siphon off reserves at a prodigious pace to push up the funds rate. Indeed, reserve balances with the Fed have dropped $2.9 billion, or 12%, in the past year. That the Fed nonetheless has greatly expanded its own balance sheet through Treasury purchases during that time is due solely to the steady drain of currency out of the banking system and into either the international drug trade or those countries where the dollar is used as a parallel currency.

In calling attention to the unfolding liquidity crunch, we have warned repeatedly that it spells a future crash. For the global bond markets, our warnings have proven right on target. But we have been wrong on the U.S. stock

market. Still, given the deterioration in liquidity and renewed unsound developments in the bond market, we see no reason to revise our crash forecast. Timing is the only question.

For the moment, however, financial markets have stabilized. The general, wishful explanation is that this is due to the U.S. economic slowdown, signalled by a growing weight of evidence. But we hope this letter has made clear the real cause: huge central-bank purchases of dollars and Treasuries. Manifestly, these purchases have been the motor driving the bond rally. Falling yields, in turn, have led many institutional investors to move from bonds into stocks. In short, foreign central banks have assumed the task of maintaining the U.S. financial bubble.

Now to the most ludicrous part of the whole story. President Clinton's trade negotiators appear determined to exploit the strong yen by provoking an all-out confrontation with Japan. Benign neglect is turning into malign neglect. This stance is emboldened by the fact that U.S. financial markets have so far proved immune to the dollar's steep fall. Modest as ever, U.S. policymakers interpret this as a vote of confidence in their policies.

Such official complacency is ridiculous, considering the most important single factor behind the American bond market's outstanding performance has been the support of the very same foreign government that is the target of the U.S. trade offensive. If the Japanese wanted to retaliate, they could play havoc with the U.S. markets.

There are several ways they could do this. The Bank of Japan could reverse its portfolio shift of last year, when it moved from buying short-term bills to buying notes and bonds. To a certain extent, this already appears to have happened, as reflected by the rally in the front end of the U.S. yield curve this year. In fact, so great have been the BoJ's purchases, for much of the past month both 3-month and the 6-month yields have traded *below* the federal-funds rate. Such an inversion is rare in a rallying bond market, except in anticipation of an imminent Fed easing.

By shifting its existing holdings from bonds and notes back to bills, the BoJ quickly could reverse the recent bond rally. This could easily trigger a major correction in the U.S. stock market, and turn the economic slowdown into a recession. As a milder alternative, the BoJ could simply channel any future dollar purchases into Eurodeposits or the overnight repo market. This also would put upward pressure on U.S. bond yields.

But there is a more dramatic option: The Bank of Japan could use its dollars to buy gold. This would send the dollar price of gold soaring, ringing alarm bells in the U.S. bond market. Mr. Greenspan, who frequently has cited his respect of the gold price as an inflation indicator, would find his hand forced. The Fed would have to raise rates.

So far, the Japanese have declined to play that card, reportedly out of respect for a gentlemen's agreement among central bankers not to a manipulate the gold price of each other's currencies. However, we would say America no longer is playing by gentlemen's rules. We can only wonder how long Japan will feel compelled to do so.

In any case, we think the Bank of Japan's present course is unsustainable. Its dollar interventions are causing tremendous distortions in the U.S. bond market. Ultimately, these can only lead to further dollar weakness.

We need to make one point clear: The Fed is not a passive bystander in this affair. The U.S. central bank could offset the Bank of Japan's bond purchases by selling Treasuries from its own $368 billion portfolio. In a sense, this would "sterilize" those foreign inflows, counteracting the artificial reduction in U.S. bond yields. It might also support the dollar by lifting the federal-funds rate high enough to attract at least some private capital inflows.

Instead, the Fed looks the other way. In fact it almost seems as if the Fed actually welcomes the current dollar crisis, which forces the Bank of Japan to bail out the bond market, and thus the overleveraged U.S. financial system. That the world's leading central bank implicitly would sanction the debasement of its own currency may seem a fantastic notion, yet that is precisely the consequence of the Fed's inaction.

Perhaps the Fed believes it has no alternative. Neutralizing the BoJ's purchases by selling Treasuries in effect would amount to a massive open-market operation, requiring the Fed to withdraw even more reserves from the banking system, aggravating the liquidity squeeze. It would also fully invert the U.S. yield curve, triggering a mass exodus of overleveraged speculators from the bond market. A repeat of last year's bond crash almost certainly would ensue.

CONCLUSIONS

While the dollar has stabilized, it's long-term bearish trend hasn't changed. The U.S. current-account deficit, the chronic global overhang of dollars, and relatively low U.S. interest rates continue to undermine it.

We would ignore the argument that the soaring yen and DM are speculative bubbles destined to pop. These currencies do not derive their strength from speculation, which we would define as the intentional creation of a currency mismatch – that is, borrowing in one currency to invest in another in hopes of profiting from a rise in the value of the purchased currency and a decline in the value of the borrowed currency. We continue to see little evidence of such speculation in the rise of the hard currencies. Indeed, Merrill Lynch's most recent survey of global investors, dated late February, found that the weighting accorded to yen assets actually has *fallen* since the yen began its meteoric rise in early 1993.

What actually is driving the yen into the stratosphere is a monumental short squeeze. Through most of last year, governments and private borrowers worldwide rushed to issue bonds in yen to take advantage of low Japanese interest rates. Generally, the yen proceeds then were converted into domestic currencies or dollars. This was a form of speculation on a rising dollar, not a rising yen. The yen's leap this year has left these debtors in a bad spot. This is particularly true of those Asian countries that have large yen liabilities but receive the bulk of their export earnings in dollars. Their obvious course is to sell their dollar holdings for yen, and to a lesser extent, for DM.

It is true such a short squeeze can take a currency to unrealistic heights. This certainly was the case with the dollar in the early 1980s. But a stream of huge U.S. current-account deficits was sufficient to deflate that bubble. We see no such corrective mechanism for the rising yen. Japan, after all, is a chronic surplus country, not a debtor.

The real risk for yen holders lies in the steady deterioration of the Japanese financial system, which creates the danger of private credit default on a massive scale. Such a development conceivably could trigger a sudden stampede away from the yen. For that reason, we repeat our long-standing advice: Guard liquidity and seek safety in the cash and short-term bonds of the European hard-currency countries, Germany, Switzerland, Austria and the Netherlands.

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